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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1931.

No.....

THE AETNA CASUALTY AND SURETY COMPANY, *Petitioner*,

v.

PHOENIX NATIONAL BANK AND TRUST COMPANY, *Respondent*.

PETITION FOR CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The petitioner, a corporation created and doing business under and by virtue of the laws of the State of Connecticut, with its principal office at Hartford in the State of Connecticut, by its counsel respectfully prays that a writ of certiorari be issued by this Court to review the judgment of the United States Circuit Court of Appeals for the Sixth Circuit in the above-entitled cause.

This was an action at law in which was sought recovery of an alleged loss by a bank under an indemnity bond alleged to have been sustained by the payment of raised and forged checks.

The indemnitor, this petitioner, defended on the grounds that:

(1) The respondent voluntarily recredited the amount of $5,512.72 which had been charged to the account of a depositor.

(2) The depositor had been grossly negligent in ascertaining the alleged loss, and, also, in notifying the bank, and by reason thereof it was precluded from any right to hold the bank, respondent here, liable for the loss.

(3) The loss, if any, was suffered by the respondent on the date it recredited the amount to the account of the depositor, and not on the date or dates it paid the raised or forged checks.

(4) The respondent was negligent in giving notice of the alleged loss to the petitioner.

(5) The respondent recredited the amount to the account of the depositor over the protest, and against the advice of the petitioner.

(6) The respondent denied to the petitioner the right to protect itself against the alleged liability by so voluntarily recrediting the amount to the account of the depositor.

(7) The respondent was legally obligated to demand payment from the endorsers of the checks within a reasonable time, before it could assert a legal claim against the petitioner, and this demand it failed and refused to make.

The trial court found:

(a) That the depositor was negligent in drawing the checks, in discovering the perpetrated frauds, and in giving notice to the respondent, and that the respondent, because of its negligence, suffered no loss for which it could hold the petitioner under its bond.

(b) That the respondent failed to comply with two legal duties which it owed the petitioner: (1) to promptly notify it of the alleged claim as soon as it was informed of it, and (2) to promptly notify the prior endorsers and demand payment of them; and by failing to perform these duties it could not shift the loss to the petitioner.

(c) That the loss alleged to have been suffered was not sustained, within the meaning of the provisions of the bond, on the date the several checks were paid, but, if suffered at all, it was on the date the recredit was made.

The trial court, therefore, entered judgment for the defendant, this petitioner.

On appeal the United States Circuit Court of Appeals reversed the judgment of the trial court.

The Appellate Court held:

(a) That the loss was complete the moment the bank paid the check over the counter or through the clearing house, and that the bond should be read as an indemnity against the *original* loss, and "not as holding the liability in the air until it can be finally determined whether the bank had a right to make the charge back."

(b) That the bank is not bound to contest with the depositor any plausible claim by the latter that it has not become liable for the loss; and that, if there should be any reasonable ground for litigation, the bank is not obliged to carry the burden of such a controversy;

(c) That the failure to call upon prior endorsers, and the failure to resist the depositor's demand for recredit were not legal defenses to the action.

Petition was duly filed for a rehearing. The petition was denied and the judgment affirmed on June 30, 1931. It is to review this judgment that the petitioner requests a writ of certiorari.

REASONS WHY A WRIT OF CERTIORARI SHOULD BE GRANTED.

(1) The opinion of the court below decides a most important question of law in a way that is untenable and in conflict with long established principles of law.

(2) The questions presented are of great importance to both banking and insurance business since there is outstanding insurance of the nature here in question representing contingent liabilities of several billions of dollars.

(3) This honorable Court has not, but should pass upon the questions here involved because of their vital importance to the business public generally.

WHEREFORE, the petitioner respectfully prays that a writ of certiorari be issued by this Court directed to the United States Circuit Court of Appeals for the Sixth Circuit directing and commanding it to produce in this Court the entire record in this case for examination and determination by it.

Respectfully submitted,

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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1931

No.....

THE AETNA CASUALTY AND SURETY COMPANY, *Petitioner*,

v.

PHOENIX NATIONAL BANK AND TRUST COMPANY, *Respondent.*

BRIEF FOR PETITIONER.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

OPINION BELOW.

The opinion below is found in 44 Federal (2d) 511 (C. C. A. 6th, 1930), and Petition for Rehearing Denied, June 30, 1931 (R. p. 111).

JURISDICTION.

The jurisdiction of this court rests on Section 240 Judicial Code as amended by Act of February 23, 1925, 43 Stat. 936.

STATEMENT OF FACTS.

This was an action at law brought by respondent against this petitioner to recover the amount of $5,512.72 on a "Banker's Blanket Bond, Standard Form No. 8, Bond No. 132522," issued by petitioner to the respondent. The bond was for $25,000.00. Under its provisions the petitioner "hereby undertakes and agrees to indemnify Phoenix National Bank and Trust Company, Lexington, Kentucky, hereinafter referred to as the insured, and hold it harmless to an amount not exceeding Twenty-five Thousand and no/100th Dollars ($25,000.00) from

and against any loss sustained by the Insured," during the life of the bond. The bond then recited the losses covered by the bond, and, inter alia:

> "D. Any loss through the payment, whether received over the counter or through the clearing house or by mail, of forged or raised checks or (genuine) checks bearing forged endorsement or the establishment of any credit to any customer on the faith of such checks." (R. p. 4.)

During the life of the bond the respondent paid 39 checks of one of its depositors, over a period from June 17, 1924, to August 1, 1925, which had been either raised or contained forged endorsements, or both. (R. pp. 69, 70.) The person who raised the checks, or forged the endorsements, or both, was the Vice President and Treasurer and member of the Board of Directors of the depositor company of the respondent, but without authority to actually sign checks. (R. p. 68.)

The frauds were discovered about August 7, 1925, or approximately 16 months after the first check was fraudulently raised. (R. p. 71.)

The bank, respondent here, sent regular monthly statements to the depositor company showing in detail all deposits made, checks paid and charges against the account during the month, and the balances to the credit of the account at the beginning and end of each month, and with the statement went the cancelled checks which had been charged to the account during the month. (R. p. 77.)

The depositor's first notice of the frauds was given to the bank, this respondent, shortly after August 7, 1925, and the first written notice was given September 25, 1925. (R. p. 71.) The first written notice of the frauds given to this petitioner was by letter from respondent dated October 2, 1925. (R. p. 71.) The petitioner made an investigation and, immediately upon completing it, advised the bank in writing that it was not liable on the bond, due to the negligence of the depositor, and the long delay in notification of the losses; also that the respondent should not admit liability, or make payment, and that the petitioner would take the defense of any suit by the depositor, and bear all expenses in connection therewith. (R. p. 72.)

Thereafter, and without the knowledge or consent of the petitioner, the respondent, on January 14, 1926, recredited the account of its depositor with the sum of Five Thousand Five Hundred Twelve Dollars Seventy-two Cents ($5,512.72), the amount of the raised or forged checks.

On February 3, 1926, the respondent filed its action against this petitioner for the sum of Five Thousand Five Hundred Twelve Dollars Seventy-two Cents ($5,512.72). Action was commenced in the Fayette Circuit Court of Kentucky, and thereafter transferred to the United States District Court for the Eastern District of Kentucky. The case was tried on stipulated facts. In two opinions, one on the pleadings, and another for judgment on the stipulation of facts, the District Court found for the defendant, this petitioner. (R. pp. 56 and 78.) On appeal the United States Circuit Court of Appeals for the Sixth Circuit reversed the judgment. (R. p. 94.) The United States Circuit Court of Appeals on petition for rehearing on behalf of the appellee, this petitioner, denied the same on June 30, 1931. (R. p. 111.)

QUESTIONS OF LAW PRESENTED.

(1) Does the negligence of the depositor of the character shown by the record relieve the bank of liability for the payment of raised or forged checks?

(2) May the bank voluntarily, and over the protest of the indemnitor, recredit to the depositor's account the amount of losses sustained as a result of the frauds here shown, and thereby force the indemnitor to pay the losses under its bond, regardless of the negligence of the depositor?

(3) Is the loss suffered by the bank of the date of payment of the checks, or of the date recredit is made to the account of the depositor?

(4) Is not question three (3) herein novel, and, as said by the lower court, is it not one of first impression?

(5) Is not the indemnitor entitled to avail itself of any deenses it may have against voluntary recredits when there is no legal obligation to make them?

(6) Does not the bank bear the responsibility of notifying

prior endorsers, within a reasonable time of known or discovered forgeries, as a protection to the indemnitor?

SPECIFICATION OF ERRORS.

The court below erred in holding:

(1) That the respondent suffered the loss on the date or dates it paid the raised or forged checks, and not on the date it recredited the amount of such checks to the accounts of the depositor.

(2) That the negligence of the depositor in discovering the frauds and in advising the respondent was not a defense to this action.

(3) That by voluntarily recrediting the amount of the raised or forged checks to the account of the depositor, over the protest and without the knowledge of the indemnitor (this petitioner), the respondent did not defeat its legal right to hold the indemnitor.

ARGUMENT.

I.

THE NEGLIGENCE OF THE DEPOSITOR RELIEVES THE BANK FROM LIABILITY FOR PAYMENT OF RAISED OR FORGED CHECKS.

The facts disclose that the checks in the instant case were so drawn that the amounts thereof might easily be raised, without exciting suspicion. They were drawn by the forger, who was Vice President and Treasurer of the depositor company, and presented by him to the proper official of the depositor company for signature. During the entire period the checks were being raised or forged (16 months), the bank made regular monthly statements to the depositor showing all checks paid, the amounts thereof, and the balance at the beginning and end of each month. Nevertheless, the depositor did not discover, or advise, the depositee of the frauds until after the person who raised the checks and made the forgeries had left its service.

It has been held that when a depositor demands a recredit for forged or raised checks charged to its account, the bank may show that the depositor failed to give reasonable notice of the forgeries which examination of the vouchers and statements revealed, or should have revealed, to the depositor.

England National Bank v. *United States*, 282 Federal 121 (C. C. A. 8th, 1922); *National Surety Company* v. *Stockyards National Bank*, 84 Colorado 563; 272 Pacific 470 (1928); *General Cigar Company* v. *First National Bank*, 290 Federal 143 (C. C. A. 9th 1923); *Stumpp* v. *Bank of New York*, 212 Appeals Division 608, 209 New York Supplement 396 (1925).

Also, in determining the sufficiency of the notification, a depositor, who innocently delegates the examination to a dishonest agent, is held to have such knowledge of the forgery as would have been revealed either through examination by an honest agent, or through reasonable supervision of the dishonest agent's examination.

First National Bank v. *Farrell*, 272 Federal 371 (C. C. A.) 3d, 1921); *Fletcher American National Bank* v. *Crescent Paper Company*, 193 Indiana 329, 139 N. E. 664 (1923); *Critten* v. *Chemical National Bank*, 171 New York 219, 63 N. E. 969 (1902); *Leather Manufacturers Bank* v. *Morgan*, 117 U. S. 96; *Pannonia Building & Loan Association* v. *West Side Trust Company*, 93 N. J. L. 377; 108 Atlantic 240 (1919); 2 Morse, Banks & Banking (6th Edition 1928) Section 472.

In *American Hominy Company* v. *Millikin National Bank*, 273 Fed. 550 (1920), the court held that a depositor was estopped by its negligence (a) in omitting to check its agent for a long lapse of time, and (b) in paying the drafts on forged endorsements.

In *Bartlett* v. *First National Bank*, 247 Illinois 490, 93 N. E. 337, the court said:

> "When one of two innocent parties must suffer loss by reason of the wrongful acts of a third party, the rule is almost universal that the party who has made it possible, by reason of his negligence, for the third party to commit the wrong must stand the loss."

To the same effect is *MacAndrews Company* v. *United States*, 23 Federal (2d) 667 (1928).

In Brady on the Law of Checks, Edition of 1915, at page 156, under the heading of "Duty of Drawer to Exercise Care in Preparing Check" appears the following quotation:

> "Speaking of negotiable instruments generally, it has been held in many jurisdictions that, where the drawer or maker of a bill or note prepares it so carelessly that alterations may easily be made, either by insertion or erasure, without defacing the instrument or exciting the suspicion of a careful man, and the opportunity thus afforded is embraced and the instrument raised in amount, the maker or drawer will be liable upon it as raised to any holder in due course. * * *
>
> "But, whatever may be the just rule in respect to promissory notes and ordinary bills of exchange, it is apparent that there is a ground on which to distinguish checks, for the relation between a bank and its depositor is essentially different from that which is found to exist between the parties to a promissory note or ordinary bill of exchange. In regard to a bill or note no one is bound, in the absence of special agreement, to purchase it or become a party to it in any manner. But a bank is bound to honor its depositor's checks at its peril. Hence it is a just rule to require the depositor to exercise reasonable care in the preparation of his checks to the end that loss may not be thrown unnecessarily upon the bank."

In the leading case, *Leather Manufacturer's National Bank* v. *Morgan*, 117 U. S. 96, 29 L. Ed. 811 (1886), this Court established the rule, which has never been changed, that a depositor's failure to examine his monthly statements of account and cancelled vouchers, and his failure to notify the bank of any error therein for a long period of time, is sufficient of itself to defeat any action by him against his bank to open up and change the stated accounts. It was held that the depositor owes the bank a duty to examine his pass-book (of which the modern equivalent is the monthly statement) and the cancelled checks returned therewith, within a reasonable time and to give the bank timely notice of any objection thereto, and that for failure to observe this rule the depositor may be estopped from later questioning the correctness of the stated account. To the same effect are *Armour* v. *Greene County State Bank*, 112 Federal 631; *Hennessy Brothers & Evans Company* v. *Memphis*

National Bank, 129 Federal 557 (1904); *Stallo* v. *Wagner*, 220 Federal 360 (1914); *General Cigar Company* v. *First National Bank of Portland*, 290 Federal 143 (1923); *Veneri* v. *Draper*, 22 Federal (2d) 33 (1927), and *Empire Trust Company* v. *Cahan*, 274 U. S. 473, wherein this Court, speaking through Mr. Justice Holmes, said:

> "* * * the transactions went on for over two years, and the petitioner (the bank) fairly might expect the respondent (the depositor) to find it out in a month or two if anything was wrong. Careful people generally look over their bank accounts rather frequently."

This same rule has been commented upon and expressed in 2 Williston on Contracts, page 2124, 31 Yale Law Journal, 598, and 24 Columbia Law Review, 469 (May, 1924).

The opinion of the Circuit Court of Appeals in this case is commented upon adversely in the Yale Law Journal, Volume XL, February, 1931, page 660.

II.

THE BANK BY VOLUNTARILY RECREDITING THE ACCOUNT OF A DEPOSITOR WITH THE AMOUNT OF THE RAISED OR FORGED CHECKS, IN THE INSTANT CASE, PRECLUDED ANY RIGHT IT POSSESSED TO HOLD THE INDEMNITOR.

The indemnitor is relieved from the payment of losses which could have been avoided, diminished or recouped elsewhere by the indemnitee. *Names* v. *Dwelling House Insurance Company*, 95 Iowa 642, 64 N. W. 628 (1895); Anson, Contracts (Corbin's Edition 1924) Section 245; 28 Columbia Law Review 202; *American Surety Company of New York* v. *Ballman, et al.* 104 Federal 634 (1900); *Thacher* v. *Aetna, etc., Company*, 287 Fed. 484 (1923).

The indemnitee is under legal obligation diligently to assert or to allow and aid the indemnitor to assert, any reasonable defense to the alleged liability. *Gorman* v. *Williams*, 117 Iowa 560, 91 N. W. 819 (1902); *City of New York* v. *Baird*, 176 N. Y. 269 (1903); *Thacher* v. *Aetna, etc., Company*, 287 Fed. 484.

III.

WHEN WAS THE LOSS SUFFERED?

The answer to this question will largely determine whether or not the judgment of the lower court should be reversed.

In the able opinion of the trial judge he said:

"* * * The loss indemnified against by the bond was a loss 'through payment,' of such checks, i. e. the loss was a consequence of such payment. The payment was not itself a loss within the purview of the bond. The payments were on account of the Petroleum Company and plaintiff at once charged the payments to it and on its books reduced its liability to it to that extent. Its books did not show any loss. The reduction in liability to that company took the place of the cash paid out. And the plaintiff suffered no real loss unless subsequently thereto the Petroleum Company repudiated those charges. This it might or might not do. It was possible, at least, that after it became aware of the forgeries, out of consideration for the forger or for some other reason, it might conclude not to repudiate the charges and to pocket the loss itself rather than let the plaintiff bear it. In such case plaintiff would suffer no loss 'through' or by reason of the payment of the checks. Further it might have no right to repudiate them. In such case it would no more suffer loss than it would where it did not in fact repudiate the payments but ratified them. This is one of the positions taken by the defendant by the allegations of its answer. It alleged that the Petroleum Company had no right to repudiate the charges which plaintiff had made against its account of the sums paid on the forged checks and it was not liable to that Company for so much of its account as had been reduced by such payments because of its negligence in three particulars, to-wit; in the drawing of the checks, in not discovering the forgeries as soon as it reasonably could after the return of the monthly statements, and in not promptly notifying defendant (plaintiff) of the forgeries after it had discovered them.

"* * * If then the allegations of the answer as to the negligences of the Petroleum Company are true the plaintiff suffered no loss by reason of the payments in question and is not entitled to recover from defendant." (R. pp. 59 and 60.)

On this point the U. S. Circuit Court of Appeals said:

> "The primary question is, when was the loss suffered? We conclude that the moment the bank paid the check over the counter or through the clearing house, its loss was complete. The relation between banker and depositor is that of debtor and creditor; the money with which the check is paid is the money of the bank; its contract with the depositor only entitles it to charge back to, and collect from, the depositor the amount of a valid check so paid. When it pays a forged check, it has no right to make this counter charge, and its loss continues to be its loss. True, the continuance is attended by a contingency,—the depositor may ratify the forgery. Such a ratification may be intentional and express, or may be implied as the result of circumstances which estop the depositor from disputing the check. So, in the present case, the loss was suffered and the liability arose from time to time as the checks were paid; and, when finally the bank cancelled the charges and recredited the total, it was not then suffering a loss; it was abandoning a claim for recoupment of its earlier loss,—a claim which at first it did not have. We think, therefore, that the policy should be read as indemnity against the original loss, and not as holding the liability in the air until it can finally be determined whether the bank had a right to make the charge back. It is not reasonable to suppose that the bank intended to buy that kind of indemnity. Banks wish to keep their depositors, not to alienate them. They would desire protection against the payments induced by forgery, not against the uncollectability of claims resulting from such payment." (R. p. 96.)

We submit that the reasoning of the trial court is sound, logical and the more reasonable. On this question we have searched in vain for authority. The expressions of the two lower courts are all we can presently find on the subject. But we submit and urge that the bond by its terms was an indemnity *against* loss and not *against liability for loss*. This distinction has been determined in somewhat similar cases. *Thacher* v. *Aetna, etc., Company*, 287 Fed. 484, 487 (1923).

Further, if the loss was complete the moment the bank paid the check, nevertheless when it charged the amount of the check against the depositor and the depositor ratified the

charge, either expressly or impliedly, the bank's original loss, if any, no longer existed.

It may be assumed, we venture to suggest, that Indemnity Insurance Companies would never write an indemnity bond which would carry with it a guarantee of indemnity immediately upon the payment by the indemnitee of raised or forged checks, without the right to assert and rely upon the long established practice of determining whether the indemnitee had a defense to the claim of the party who asserted the loss. The judgment of the Circuit Court of Appeals not only denies, and completely ignores this well recognized right, but at the same time relieves the depositor from all negligence, however gross. It is not only the right but the duty of the Insurance Company to pay losses only after they are determined, upon investigation to be final, legal and actual.

A determination of the other questions presented depends upon the answer of this Court to the question: "When did the loss occur?" and we do not deem it proper to further burden the Court with the discussions of them, as we confidently believe that this Court will lay down the rule definitely and finally that the bank suffers a loss within the purview of this indemnity bond when, after investigation discloses that the loss is final, legal and actual, it recredits the account of the depositor with the amount paid on raised or forged checks. Any other rule would open wide the doors for fraud to be perpetrated not only on the bank but also on the indemnitor and deny to both the long established right and duty to assert proper defenses to all claims for losses.

Respectfully submitted,

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